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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

June 29, 1994

William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Mr. Caton:

Re: *CC Docket No. 94-1, Price Cap Performance Review for Local Exchange Carriers*

On behalf of Pacific Bell and Nevada Bell, please find enclosed an original and six copies of their *"Reply Comments"* in the above proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

Jo Ann Goddard

Enclosures

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JUN 2 9 1994

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	

REPLY COMMENTS OF PACIFIC BELL AND NEVADA BELL

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Date: June 29, 1994

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SUMMARY

The comments that were filed in this proceeding fall easily into two categories. The first category is of those who, though they might pay lip service to the success of price cap regulation, look to the past and advocate the reintroduction of rate of return (ROR) principles. The second category comprises those who look to the future. We advocate removing ROR artifacts from the price cap rules. We're willing to assume more business risk if we're also allowed to keep the fruits of our labors. We support the reform of anticompetitive rules that hurt consumers by handicapping competing providers with unequal preferences and unequal burdens.

While the nation's economy is showing moderate expansion, our franchise area has only just begun to recover from its worst recession in fifty years. California is also the most urbanized state in the country, and therefore the most vulnerable to cherry-picking by providers who aren't subject to the same universal service obligations, price controls, and other rules that we are. In our Comments we demonstrated the positive effect that pure price cap regulation and access reform would have on the economy. If reform is stymied and we roll back towards ROR regulation, our region could be especially hard hit. Instead of telecommunications capital flowing into California, it would probably flow into networks abroad.

There should be no retreat from price cap regulation. The Commission can't finesse this issue. There are only two directions in which the Commission can move: forwards toward

price cap regulation, or backwards toward ROR. The reasons to move forward are obvious. There is one overriding reason not to move backwards: ROR regulation can't coexist with widespread competition. We don't have the market power anymore to assure recovery of our costs on a ROR basis. A veiled return to ROR regulation (for example, through "productivity" adjustments based on interstate earnings) could be a windfall for our competitors but financially devastating for us.

The Backstop Mechanisms. Earnings caps, sharing, and the lower formula adjustment mechanism (LFAM) dull the incentive to be efficient, productive, and innovative. Nobody really contests this. Nor can anyone deny that earnings limitations artificially and needlessly discourage investors from investing in the American network of the future.

Nonetheless some parties want the goalposts moved in a way that would mark a virtually complete return to ROR regulation. AT&T, for example, would reduce our rates in accordance with its assessment of our current cost of capital. This used to be known as a represcription of the rate of return. But it's inconsistent with price cap regulation, which broke the link between costs and prices. This is not to say it would be as fair as cost-of-service regulation. None of the IXCs has proposed that we be compensated for unexpected cost increases. AT&T's position on our cost of capital is an example of "heads we win -- tails you lose."

A ROR represcription would also, at this point, be unlawful. The Part 65 rules have never been revised to reflect the existence of competition. The methods they contain for calculating our cost of capital don't work in a competitive industry. The Commission itself has expressed misgivings about the Part 65 rules but has never actually amended them. Even if the Part 65 rules were adequate, we've not had a full opportunity for hearing on our cost of capital. The methods used by AT&T, MCI, and others to demonstrate our cost of capital are flawed. The represcriptions they advocate could threaten our financial integrity.

The Productivity Factor. This is another easy way to destroy the incentives in "incentive" regulation. Rather than measuring productivity, some parties measure interstate earnings and derive the "productivity" factor that's allegedly needed to return those earnings to some arbitrary level. This would be contrary to price cap principles, and would return to our IXC competitors all our hard-won efficiency gains. It may resemble a rate of return represcription, but it's actually worse than that, since any productivity adjustment would be a permanent, compounding reduction of revenues.

Four years ago the Commission adopted a productivity factor that was too high because it was biased toward the short term. It's time to correct that mistake. We've presented evidence that our actual long-term total factor productivity has been about 1.7% above that of the nation. No party presented a valid TFP study showing greater historical productivity than this. The current 3.3% productivity factor should be reduced or eliminated.

AT&T is one of the parties that advocates an earnings-based increase in our productivity factor. Yet as AT&T said not long ago in its own price cap review proceeding, an increase in the productivity factor because of earnings would "violate the rationale and undermine the benefits of price cap regulation by reintroducing the worst features rate of return regulation ... all of the many benefits of price cap regulation stem from [the] potential for increased profitability." The Commission accepted this position. AT&T is legally free to be hypocritical. The Commission isn't. If it changes course -- increasing our productivity factor because of earnings, but not AT&T's -- it will have to explain why it has acted inconsistently.

<u>Reforming Anticompetitive Rules</u>. In our Comments (p. 25) we described how price controls have proliferated since price caps began, even though we undoubtedly need more flexibility to survive competition with our financial integrity intact. Yet every one of our competitors seems to have a plan for more price controls. Not one of these plans permits us to price competitive services based on relevant costs, as our competitors can do. There are two lessons here for the Commission.

First, <u>price controls in competitive markets destroy consumer welfare</u>. The assertion that "as more competition develops, more price regulation will be needed" is just as bankrupt as it sounds. The most formidable competitive issue facing the Commission isn't difficult to resolve intellectually.

But it will take courage to resolve morally. The issue is protectionism. As Judge Stephen Breyer said some years ago,

> [The problem] arises when regulators or antitrust enforcers confuse means with ends by thinking that the object of the law is to protect individual firms from business risks rather than to bring consumers the price and production benefits that typically arise from the competitive process ... the consequence of misdirecting protection is to threaten to deprive the consumer of the very benefits that deregulation seeks.

"The most obvious" example of this risk, Breyer pointed out, "arises in telecommunications."[1] Breyer went on to debunk most of the reasons advanced for handicapping the long distance business. The Commission's regulatory philosophy toward AT&T has progressed somewhat since that time. But read "the BOCs" for "AT&T," and Breyer's observations (which we discuss below) still ring true.

In some of our most significant markets, competitors have flourished under an umbrella that prevents us from pricing based on economic costs. Our competitors are extracting supracompetitive profits from consumers. We aren't referring just to CAPs. According to the Commission, household interstate long distance rates increased 6.5% in 1992 and 9.6% in 1993 at the same time LEC interstate access charges fell by hundreds by

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[1] Stephen G. Breyer, "Antitrust, Deregulation, and the Newly Liberated Marketplace," California Law Review, vol. 75, p. 1018 (May 1987).

millions of dollars.[2] Not content with the price increases of 1992 and 1993, AT&T has already raised its interstate rates twice in 1994: once in January and once in June.[3]

There's something wrong with this picture, and it's not that we have excessive market power. If recent history is any guide, the ROR-inspired rate reductions that AT&T, MCI, and others propose for us won't benefit consumers.

Second, price controls in competitive markets will embroil the Commission in unprincipled disputes between competitors. Our competitors don't need any protection. AT&T's 1993 revenues were about seven times ours.[4] AT&T is the market leader in cellular and long distance, and it has a near lock on the world market for major equipment. MCI is flush with $4.3B in cash from British Telecom, which MCI has announced it will use to

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[2] Industry Analysis Division, FCC, Trends in Telephone Service, May 1994, Table 5 at p. 8. The Tier 1 LECs and NECA reduced access charges by $184 million in 1993 and $463 million in 1992. See 1993 Annual Access Charge Filings, 8 FCC Rcd. 4960, para. 2 (1993); 1992 Annual Access Charge Filings, 7 FCC Rcd. 4731, para. 2 (1992).

[3] See "AT&T Seeks Some Business Rate Increases," New York Times, Jan. 25, 1994, at D3; Los Angeles Times, May 16, 1994, at D2.

AT&T recently contended that (1) accusations it has increased prices are not based on FCC data; and (2) its revenues per minute have declined under price caps. Ex Parte Letter from Charles L. Ward to William F. Caton, Docket 87-313, dated June 10, 1994. The first contention is simply untrue; the price increases have been reported by the Industry Analysis Division (n.1 above). The second contention misses the mark. AT&T's access costs went down. AT&T's rates went up. What happened to AT&T's revenues per minute is of slight interest at best.

[4] The disparity may be expected to widen considerably. We spun off our cellular business in 1994. AT&T will acquire McCaw. Our revenues from the wireline business have been essentially flat. AT&T's have grown, under price cap regulation, by hundreds of millions.

expand its local exchange network as well as invest abroad.[5] Sprint has just allied with France Telecom and Deutsche Bundespost Telekom, who have bought into Sprint at a premium of more than 20% over Sprint's current market value.[6] But no oligopoly would be complete without AT&T. It has threatened to spend $350M of its "own" money -- for which we read profits from its American operations -- on a European network if it doesn't find partners overseas.[7] The suggestion that we must be constrained through more price controls because otherwise we could leverage providers like these out of our markets is incredible.

The Commission can no longer consider our financial integrity in isolation. We now compete with providers from all over the world for customers <u>and</u> for capital. Investors put their capital where it will earn the highest return commensurate with risk. In the unlikely event the Commission wants to maintain IXC profit margins and stimulate investment abroad rather than at home, there's an easy way for it to do so. Adopt some variation on AT&T's or MCI's proposals. Penalize investment in our networks, maintain the rules that discourage efficiency but protect other providers from competition, and turn over to them any productivity gains of our own.

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5 See MCI, p. 69.

6 "Sprint Deal Raises Spector of Trade Flap," Wall Street Journal, Wednesday, June 15, 1994, p. B2.

7 "AT&T Plans To Join Forces With Europeans," Wall Street Journal, Thursday, June 23, 1994, p. A3.

Asymmetrical regulation of competitive markets is a slippery slope. It ends, as the Court of Appeals for the Seventh Circuit has remarked, in "unprincipled compromises of Rube Goldberg complexity among contending interest groups viewed merely as clamoring suppliants who have somehow to be conciliated."[8] It invites unreasoned decisionmaking. In three months, the courts have reversed three separate attempts by the Commission to handicap competitive markets.[9] It's noteworthy that one of the small number of recent common carrier actions to have been affirmed on appeal was the price cap decision itself. It was a progressive piece of work. But the work remains unfinished.

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8 Schurz Communications v. FCC, 982 F.2d 1043, 1050 (7th Cir. 1992).

9 MCI Telecommunications Inc. v. AT&T, No. 93-358 (U.S. June 17, 1994); Bell Atlantic Tel. Co. v. FCC, No. 92-1619 (D.C. Cir. June 10, 1994); Southwestern Bell Tel. Co. v. FCC, No. 91-1416 (D.C. Cir. April 5, 1994).

TABLE 1

Earnings of U.S. Telecommunications Providers

Company	Sales Latest 12 Months	Return on Equity (5-year average)	Return on Capital Latest 12 Months
AT&T	$66.2B	14.9%	13.4%
GTE	$19.8B	15.3%	9.4%
BellSouth	$15.7B	12.2%	7.7%
NYNEX	$13.3B	10.3%	7.9%
Bell Atlantic	$12.9B	14.1%	10.0%
MCI	$11.6B	27.2%	11.3%
Ameritech	$11.5B	15.1%	11.9%
Sprint	$11.1B	NA	8.7%
Southwestern	$10.5B	13.1%	8.8%
US West	$10.3B	11.1%	4.3%
Pacific	$10.2B	13.6%	7.2%

Source: Julie Pitta, "The 46th Annual Report on American Industry; Computers and Communications", Forbes, January 3, 1994, at p. 120.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1

REPLY COMMENTS OF PACIFIC BELL AND NEVADA BELL

Pacific Bell and Nevada Bell respectfully submit the following reply to comments filed in this proceeding.[1]

In our comments we said that the single best way to promote goals such as the development of a National Information Infrastructure (NII), new services and technologies, economic growth (including job growth), and network efficiency, would be to eliminate the backstop mechanisms (earnings caps, sharing, and the "lower formula adjustment mechanism" or LFAM). On our behalf, USTA submitted expert testimony from Dr. Robert Harris; the National Economic Research Associates (NERA); Dr. Larry Darby; Christensen Associates; Dr. Lawrence K. Vanston; and the WEFA Group. Together they showed the positive effect that price cap regulation has had on the nation's economy and the even greater effect it could have if vestiges of rate of return (ROR) regulation were removed. The Commission should also reduce or eliminate the current 3.3% productivity factor, which

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[1] Comments were filed by, among others: AT&T, MCI, Ad Hoc, ARINC, GSA, OCCO, ICA, ETI, WilTel, CompTel, MFS, TCA, TCG, ICI, US Sprint, and Time-Warner.

Christensen Associates showed is now nearly double what our long-term total factor productivity (TFP) actually has been.

To preserve universal service and increase consumer welfare, it is also not just advisable but essential for LECs to be able to respond to competitive challenges as competitive enterprises do. We endorsed USTA's plan for segmenting markets and permitting pricing flexibility in the markets where competitive entry has already occurred and customers have choices.

I. THERE SHOULD BE NO RETREAT FROM PRICE CAP REGULATION.

Some parties openly deny that price cap regulation is good for the economy (see, e.g., Ad Hoc, pp. 6-10). Others seek a return to ROR regulation that is more thinly veiled. They argue that earnings caps and sharing (though not necessarily the LFAM) should not only continue, but should be linked to a substantially lower rate of return than under the current rules. (See, e.g., AT&T, p. 29-30; MCI, p. 29; Ad Hoc, p. 25; ARINC, pp. 3-4.) Other parties argue for more price controls. Finally, some parties argue for an increase in the productivity factor, based on earnings-derived methods that seek to assure that not only all future efficiency gains but also past efficiency gains we earned will accrue to them.

There should be no retreat from price cap regulation. The Commission cannot finesse this issue. If it changes the rules, it can only make them more like price cap regulation, or more like ROR regulation. By eliminating ROR artifacts like the backstop mechanisms from the rules, the Commission would expose us to considerably greater risk than we faced four years ago. We'd welcome this additional risk, because the alternatives are all worse.

AT&T, MCI and our other competitors want to keep our industry alive -- but only barely. The current rules under which we must operate allow them to select and exploit profitable markets without any obligation to serve the unprofitable ones. It's in their interest to keep things this way, and to constrain our financial capability to compete effectively. For example, AT&T proposes a rate true-up that, without apology, would return to <u>its</u> shareholders and the shareholders of other access customers all of the financial benefits of price cap regulation, leaving none for us. With the IXC price increases in 1992, 1993, and 1994 (see above, p. vi), the Commission cannot pretend that the IXCs' proposals for new price controls or rate reductions based on ROR principles would benefit consumers.

AT&T has presented the most nakedly disingenuous position of any party in this proceeding. During its own price cap rule review, AT&T presented positions both on (1) earnings and productivity under price cap regulation, and (2) the significance of market segmentation and market power in a competitive landscape, that are completely at odds with the positions it advocates in this proceeding. The Commission has a right to know what a quagmire of self-serving contradictions it will have to sift through if it applies asymmetrical regulation to competitive markets.

The alternative to price cap regulation and pricing reform is simply unacceptable: it is for the Commission to subject vigorously competitive markets to asymmetrical regulation, unequally dividing rights and responsibilities between rivals while somehow doing perfect equity by consumers. This would be futile. When prices in competitive markets are regulated, economically inefficient providers are encouraged to enter, a political constituency for anticompetitive rules is born, and consumer welfare suffers.[2]

A. The Effect of Price Cap Regulation on the Economy

In its NPRM the Commission solicited comments on the effect of the LEC price cap plan on consumer welfare, the economy and the creation of jobs both in telecommunications and elsewhere. On our behalf, USTA submitted comprehensive expert evidence showing that the modest changes we propose in the price cap plan would provide important positive benefits. As Professor Harris summarized, "[e]ach of these studies -- and numerous others -- have confirmed that the direct user benefits, and direct and indirect economic development benefits of telecommunications are, if anything, growing over time."[3] A

2 See Harris June 29, 1994 Report, pp. 20-21.

3 Harris May 9, 1994 Report, pp. A-7 to A-10.

recent study by the U.S. Council of Economic Advisors (CEA) provides further support for this conclusion.[4]

The only party that challenged this was the Ad Hoc Telecommunications Users Committee ("Ad Hoc"). Ad Hoc presents an analysis by its alter ego, Economics and Technology, Inc. ("ETI"), which concludes that "[p]erceptions of linkage between price caps and broad economic objectives are illusory, ill-conceived, and ignore other relevant factors." (Ad Hoc, p. 6.) ETI supports its contention with an analysis based on three statistical models. None of these models proves ETI's conclusion.

ETI's first model is a simple regression analysis between telephone density and per capita GNP. But telephone density isn't a good measure of telecommunications investment. No conclusions can be drawn from this study about telecommunications investment's effect on the economy.

ETI's second model tests the relationship between telecommunications investment and GDP. This "improved" model finds a linkage between the two for countries with low telephone densities, but not for those with higher telephone densities. This model only includes data from fourteen countries -- too few to support ETI's sweeping conclusions. More information should have been included to improve the model's integrity. ETI's investment and GDP data are unadjusted for inflation, and the

[4] U.S. Council of Economic Advisors, Economic Benefits of the Administration's Legislative Proposals for Telecommunications, June 14, 1994.

model inappropriately combines various types of telecommunications investment.

ETI's third model is intended to measure the net effect of an "increase in LEC spending that is financed with an implicit tax on consumers representing the additional rates charged solely for the purpose of improving the infrastructure." (ETI, p. 26.) This model is outdated. It was developed by Lawrence Klein in 1950. ETI found it in a college textbook, where it's provided to teach students econometric techniques.[5] The model is very simple and doesn't include a telecommunications sector. The "dynamic multipliers and interrelationships" in this model (ETI, p. 24) are for the 1921 to 1941 period, and the textbook leaves it to the student to update the model.[6] ETI didn't.

ETI's 1950 model is an early forerunner to WEFA's current Mark 10 model. However, WEFA's model includes almost a half century of enhancements and expansions. It's no exaggeration to say that ETI's model is to WEFA's model as a biplane is to a B-1 bomber. It's one thing if ETI didn't have the financial resources to update an outdated textbook model. It's another for ETI to present the results of such a model as sound evidence. This proceeding is not a classroom exercise.

The proposition that pure price cap regulation will lead to lower access charges and greater telecommunications investment was not seriously challenged. The only real issue is

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[5] William H. Greene, Econometric Analysis (2d ed. 1993).

[6] Greene, p. 628.

who will reap the efficiency gains of price cap regulation: American consumers; or the shareholders or world customers of AT&T-McCaw, MCI-BT, Sprint-FT-DBT, or our other competitors. At the same time that U.S. access charges fell by hundreds of millions of dollars, the major IXCs have raised their prices to end users and stepped up their investments abroad. Unless ROR artifacts and anticompetitive rules are removed from incentive regulation, American consumers may not benefit from future access charge reductions.

B. The Backstop Mechanisms

By diluting incentives, the backstop mechanisms dilute the signals that make price cap regulation work.[7] This is incontestable. Therefore none of the parties who advocate adding to the ROR vestiges in the rules, and subtracting price cap features, actually admit it.

AT&T's approach is typical. It begins innocuously enough:

> Overall, the Commission's incentive regulation plan for local exchange carriers ("LECs") represents a substantial improvement over rate-of-return regulation of those carriers, and thus should be retained as a regulatory model. The Commission's adoption of LEC price caps has resulted in interstate access rates $1.5 billion lower than at the inception of the LEC price cap plan, while providing incentives to the LECs to become more

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[7] See NPRM, para. 47, pp. 20-21; and Southwestern Bell Comments, Appendix SPR, Regulatory Reform for the Information Age: Providing the Vision, Strategic Policy Research, January 11, 1994.

efficient, productive and innovative. The structure of the price cap plan should therefore be retained.

(AT&T, p. i.) These are all true assertions.

AT&T then calls for asymmetric reform of the backstop mechanisms: it argues for retaining the sharing mechanism, while lowering the sharing threshold to reflect its assessment of our cost of capital (a euphemism for ROR); and it proposes elimination of the lower formula adjustment (AT&T, p. 30). Finally, AT&T (and some other parties) call for increasing the productivity factor to give back the increased earnings they say have resulted from the first four years of price cap regulation.

AT&T's proposals would turn a rulemaking on incentive regulation into a traditional rate case, one in which our ROR would be represcribed and our rates reduced to correspond to alleged reductions in some input costs (but <u>not</u>, of course, increases in others). (AT&T, Appendix E, pp. E1-E5.) This would be bad law and bad policy.[8]

USTA's Reply Comments in this proceeding include expert testimony by Dr. Randall Billingsley. We caution that Dr. Billingsley's study was undertaken <u>only</u> to point out the more egregious errors in the cost of capital estimates proposed by AT&T and MCI. Adjustments to rate of return have no place in a price cap form of regulation, the goal of which is to control <u>prices</u> and not individual endogenous costs. This proceeding

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[8] MCI also supposedly supports the continued use of price cap regulation (MCI, p. i) but it proposes that our ROR be adjusted to 9.54%.

cannot substitute for a rate of return represcription proceeding, without running afoul of the Hope[9] and Bluefield[10] standards or the Section 205 requirement for a "full opportunity for hearing" on these issues.[11] This is especially so in view of the doubts the Commission has expressed about the continued validity of the Part 65 rules for determining rates of return.[12]

Even so, using comprehensive methodologies, Dr. Billingsley shows that the LECs' current cost of capital is between 11.64% to 11.82%, significantly above the last ROR prescription (11.25%) made by the Commission in 1990. As Dr. Billingsley shows, both AT&T's and MCI's "cost of capital" studies are flawed. They fail to provide a full and comprehensive review of the cost of capital even if such a cost of capital recalculation were appropriate.[13] Essentially, AT&T

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9 Hope Natural Gas Co. v. Federal Power Commission, 320 U.S. 591 (1944).

10 Bluefield Water Works v. PSC of W. Va., 262 U.S. 679 (1923).

11 47 U.S.C. §205.

12 Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Processes, 7 FCC Rcd. 4688 (1992) (Represcription Reform NPRM).

13 ARINC (P. 3) and GSA (p. 6) also recommend an immediate ROR represcription.

and MCI have merely plugged newer data into the DCF model that is preserved, as an artifact, in the Part 65 rules.[14]

It's not necessary to take our word for it. AT&T (AT&T, at D-5) and MCI (Kahal, at Table 9) contend that investors require a return of about 11.0% on the market price of our stock. Given recent share prices for our stock of between $30 and $33 per share and an average 1993 number of shares outstanding of 414 million, our total equity investment value is about $13 billion. An 11% return on this equity would, therefore, require net income of $1.43 billion.

AT&T estimates our historical cost of debt was 8.36% in 1993 (AT&T, at D-5), while MCI estimates a recent cost of debt for Pacific Telesis at 9.016% (Kahal, at Table 7). The average of these two estimates is 8.7%. MCI states that Pacific's 1993 average debt outstanding was about $5.8 billion (Kahal, at Table 8). Thus, approximately $505 million would be required to meet debt service obligations.

Based on AT&T's and MCI's estimates, therefore, Pacific's total capital costs required to meet equity return requirements and debt service obligations is $1.935 billion. Given Pacific Bell's total ratebase of approximately $12.5 billion, to meet the investor expectations determined by AT&T

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[14] AT&T's Model is "based on the proposition that the price of a company's stock equals the present value of future dividends per share discounted by the company's cost of equity capital." (AT&T, at D-1). AT&T explains that "[A]ccording to this DCF formula, the return investors expect to earn on a share of common stock (Ke) equals the dividend yield they receive from that share (D/P), plus the long-term growth they expect in earnings (g)" (AT&T, p. D-2).

and MCI, based on traditional ROR parameters, would require earnings of about 15.5% -- not the 9% to 10% that AT&T and MCI suggest. In fact, the 9% to 10% return proposed by AT&T and MCI would fail to meet Pacific Telesis' current dividend yield requirement (D/P) as defined in the DCF Model used by AT&T and MCI. See Figure 1.

The Commission has recognized limitations in this DCF Model, and made its intention clear to revise ROR methodologies prior to another represcription. That revision hasn't yet occurred.[15] The Part 65 rules have twice been determined to be deficient.[16] And in Docket 92-133 the Commission recognized the need to modify the Part 65 rules before deriving an interstate cost of capital. The Commission said, "[s]ince the adoption of the Part 65 Rules in 1985, the telecommunications industry and our regulation of it have changed considerably."[17] No permanent modifications have been adopted. The issues raised in Docket 92-133 remain unresolved.

In contrast to the evidence that cost of capital changes are already included in the GNP-PI,[18] AT&T asserts (p. 33, n.45) that the telecommunications industry is more capital intensive than the average firm in the general economy.

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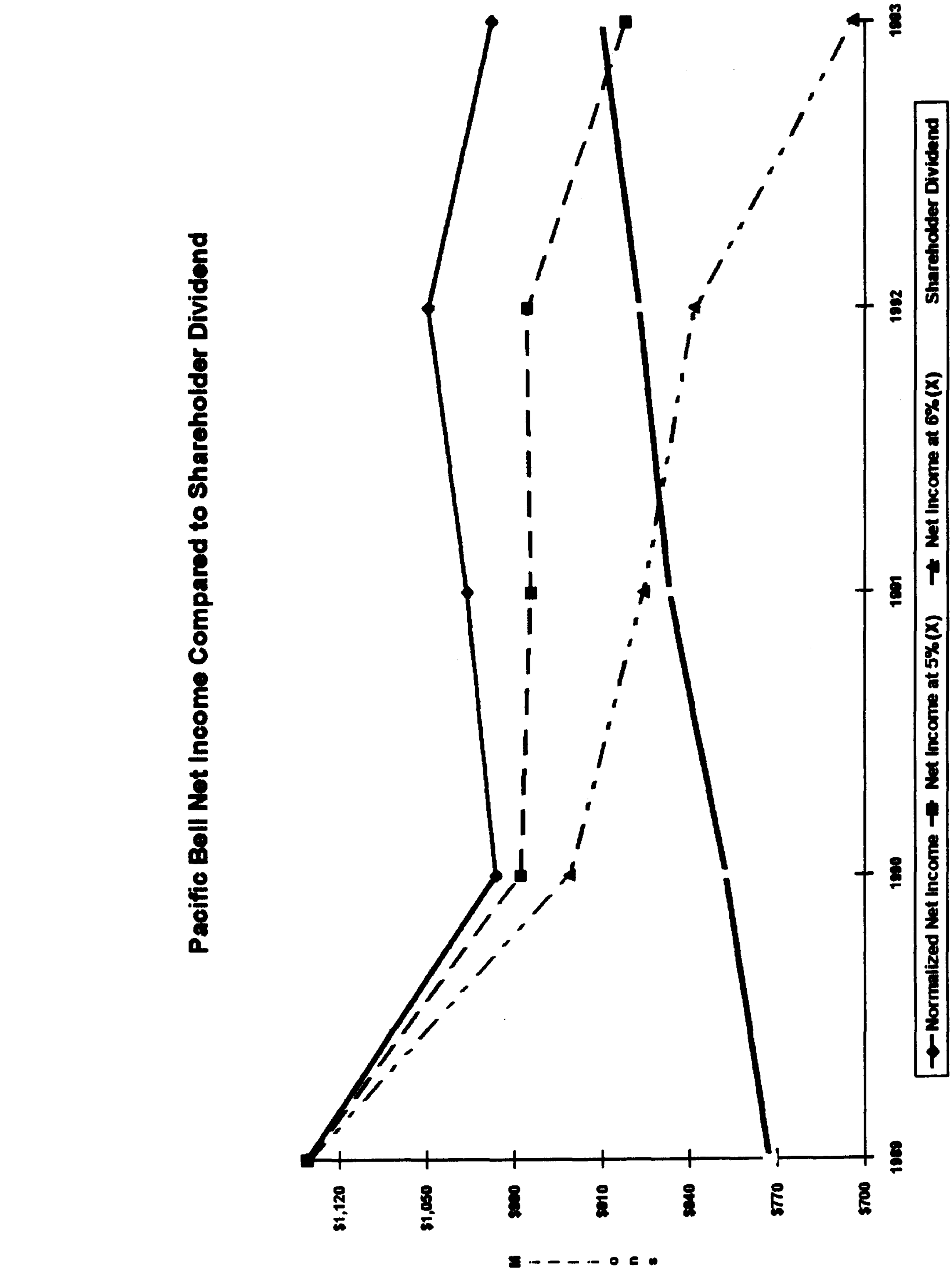
15 Represcription Reform NPRM, para. 19.

16 See Refinement of Procedures and Methodologies for Represcribing Interstate Rates of Return for AT&T Communication and Local Exchange Carriers, 7 FCC Rcd. 5949, para. 19 (1992); Represcription Reform NPRM.

17 Represcription Reform NPRM, para. 14.

18 See Pacific, p. 34.

Figure 1
(follows p. 11)



NERA, however, has fully explained that the overall growth in input prices for the telecommunications industry averages about the same rate of growth as input prices for the economy as a whole.[19] This means that over time the overall growth in the prices that telecommunications firms pay for capital and labor and materials is about the same as the growth rate of these prices for the general economy. In short, there's no basis for an adjustment for changes in input capital costs without similar adjustments for changes in other input costs.[20]

The CPUC recently rejected an attempt to make changes for alleged differences in input costs, including interest rate changes. It said:

> Adjusting Pacific's rates for changes in a specific input price (*e.g.*, a change in the cost of capital) is no different conceptually than using an annual Z-factor adjustment to reflect changes in an individual input factor price. In general, such treatment is inconsistent with the proper working of price cap regulation because it removes the firm's incentive to bargain vigorously in its input markets. The prices for many inputs have undoubtedly changed (in real and relative terms) since price caps began. There is no basis for singling out the cost of capital. Adjustments for any and all such changes would be a return to the old days of cost of service regulation.[21]

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19 NERA May 9, 1994 Report, pp. 14-16.

20 See NERA June 29, 1994 Report, p. 38.

21 *Application of GTE Calif. Inc. (U-1002-C) for review of the operations of the incentive-based regulatory framework adopted in D.89-10-031*, D.94-06-111, pp. 58-59, quoting Dr. Taylor.